PRIVATE COMPANIES CASH IN ON "PRIVATE" INSURANCE

MANY ARE SELF-INSURING RISKS THROUGH A "PURE CAPTIVE."

BY CATHIE BECK

When Stephen Francis, president of CQG, Inc., a Denver, Colo.-based company that provides real-time financial data and analytics software to financial traders, saw that his insurance risk program neglected coverage for risks specific to his business, he realized that his company needed to seek protection outside the traditional risk management methods. CQG's conventional insurance policies failed to target very specific dangers within his business. So he looked around and discovered a relatively new product available to medium-sized companies: a privately owned insurance company of his own, also known as a "pure captive."

"We have risks unique to our business," Francis says. "For example, business interruption risks like Internet crashes. So we turned to the captive or private insurance company as a risk management tool. Setting up a private insurance company allows us to identify, quantify, and price those particular risks and put them into a separate company."

WHAT IS A CAPTIVE INSURANCE COMPANY?

In its simplest definition, a captive insurance company is an insurance company essentially owned by the insured. The core purpose of a captive is to better manage self-insured risks.

But in a carefully structured captive, additional benefits can affect a company's bottom line. Those benefits can include tax advantages, money saved, potential investment income, and the ability to manage insurance claims in-house. "Our captive allows us to insure specific business risks," Francis notes, "but we can also isolate and manage those risks separate from our regular operations. We also save money on insurance premiums and agency commissions."

Moreover, a properly structured private insurance company can help build surplus capital over time, allowing companies to better price their existing third-party insurance program.

Intuitive Captive Solutions (ICS), a Denver, Colo.-based company that developed the "CapPlus" captive product in 2006, helped Francis create CQG's private insurance company. ICS Managing Partners Jim Landis, Howard Potter, and Rick Eldridge have more than 40 collective years of experience in law, captive creation, insurance, and risk management. The company formed in perhaps one of the most ominous years for risk management in the last several decades—when Hurricane Katrina struck the Gulf Coast in 2005. Changing thousands of lives and altering an entire region's economy, the disaster in many ways obliterated traditional risk management equations.

Working primarily in manufacturing, real estate, and other industries to craft private insurance companies, the ICS management team realized that many regionally based companies could no longer purchase adequate insurance from the standard insurance market in the wake of such devastation.

OWNERS HAVE CONTROL

"IRS rulings that changed a few years back altered the scope of who could form a captive insurance company," Jim Landis explains. "Private insurance companies are now accessible and powerful vehicles for midsized companies to establish pre-tax reserves for exposures that might otherwise be left uninsured. Unlike 'group' captives or 'offshore' captives, the new CapPlus gives the entrepreneur full control over his risks and rewards.

"Historically, captives have been created for *Fortune* 1,000 companies who had a lot of cash available to manage risks. Those companies recognized that by self-insuring certain risks (such as product liability, officers' liability, and large property risks), they could squeeze out the marketing costs of the middle men (the agent and traditional insurance companies) while gaining direct access to the reinsurance market," he adds. "Put simply, the economics of captive insurance companies were previously unaffordable for midsized companies. All that has changed dramatically, yet most companies remain unaware of both the changes and the availability of an effective, custom-designed private insurance company and what it can do to help a company manage risk efficiently and increase its ultimate net worth."

While not a catchall for covering all of a company's potential risks, a simple captive affords a closely held company the opportunity to self-design risk management in a way that has heretofore been unattainable. "Most midsized companies with insurance expenses that are greater than $300,000 and taxable income of $4 million to $5 million or more can now create their own private insurance company to supplement their existing third-party insurance," Rick Eldridge says. "This concept brings an unusual opportunity to entrepreneurs. They are in a much better position to manage their risks while also capturing some of the profits they had been previously giving to insurance companies."

AIDING RISK MANAGEMENT

Probably no one has more experience in captive development in the U.S. than William P. "Bill" White, who serves as the administrator of the Delaware Captive Insurance Program. White formerly served as the director of the Captive Insurance Division for the Department of Insurance Securities and Banking in Washington, D.C. During his tenure there, he was key to developing Washington as a leading domestic domicile for captive insurance business. In other words, he helped bring captives to the U.S. Prior to his work, captives were traditionally considered "offshore" vehicles for mega-corporations only.

Currently working to implement Delaware's recently adopted Captive Insurance Law, White views the captive as a timely, appropriate, and organic element to a company's overall risk management strategy. "Captive insurance companies are a key part of the overall risk finance picture," he says. "I don't view them as a separate part of the insurance market but rather as an alternative risk transfer (ART) vehicle that can be used to address specific exposure to loss situations. In combination with traditional risk transfer mechanisms, establishing a captive insurance company can assist an organization in defining and measuring its risk appetite for more effective use of risk finance capital."

Moreover, in helping to design and implement captive insurance law over the past several years, White has come to recognize the captive not as an extra or extraneous risk management concept but as a necessary and valuable tool to a company's ultimate economic integrity. "It has become apparent that many medium-sized companies face some of the same finance risk problems as larger companies, except they historically did not have the size, on an individual basis, to develop a risk transfer vehicle in a cost-effective manner," White notes. "Gaining certain tax benefits changes the equation, allowing smaller captive insurance companies of various types to better serve this market.

"The distinction between alternative risk transfer and traditional markets is continuing to become less apparent and less important as definitions of risk evolve," he adds. "Recently, we have seen a push toward captive insurance companies and ART mechanisms focused on accessing the capital markets as the need for risk capacity continues to grow. I expect this trend to continue over the next few years as our understanding of risk elements and the tools we use to measure risk become more sophisticated."

"Business owners manage risks in two primary ways," Eldridge explains. "One is the purchase of medical, property, and casualty insurance from the 'standard' insurance market, and the second is the development of safety and other programs designed to minimize losses not covered by third-party insurance, usually referred to as 'self-insured' risks. If a company is large enough, some of the risks that are placed in the standard insurance market and those that are currently self-insured can justify the formation of a private insurance company to better manage and finance those risks.

"The updated tax rules make the formation of a private insurance company compelling for profitable, closely held businesses," he adds, "and they also simultaneously create estate planning opportunities for the entrepreneur."

ESTATE PLANNING, TOO

The phrases "estate planning," "risk management," and "private insurance company" have traditionally not been created and crafted together as a unified economic front for the owners of medium-sized businesses. But because of the domestic captive insurance developments of recent years, it now makes fiduciary sense for owners of closely held businesses to examine a private insurance company in terms of evaluating how it can fit into an estate plan.

"One of the basic objectives of estate planning is to transfer wealth to the next generation while minimizing the tax consequences of such transfers," Jerry Middel, principal of Financial Designs, Ltd., a leading estate planning firm in Denver, says. "One way to make such transfers is to form a new company owned by the children and have the parent's company do business with the new (the children's) company. However, such an approach is rife with risks and may not be economically feasible since the new company will pay taxes on income received from the parent's company.

"Owning a private insurance company can solve this dilemma," Middel explains. "As a small insurance company, it may not have to pay income taxes on its premium income—yet the parent's company may still be entitled to deduct the entire amount paid to the insurance company. If the children (or a trust for the children or grandchildren) own the new insurance company, and if that insurance company is profitable, then the parent is able to transfer up to $1.2 million each year to the next generation while taking a current income tax deduction for insurance premiums paid. Once the insurance company settles all claims made

Ask the Right Questions

If you are thinking about creating a private insurance company, you need to answer several questions first so you can make sure it's the right thing to do.

1. Do current policies provide the coverage needed at a reasonable cost?
2. Has there ever been a loss not covered by an insurance policy?
3. Is there existing insurance that hasn't had a recent claim?
4. What is the quantified amount of risk currently self-insured?
5. Does the company have sufficient cash flow to fund self-insured risks through a captive?
6. Does the company need additional tax deductions?
7. Does the company pay at least $300,000 in annual premiums for its existing insurance program?
8. Is the company closely held?
9. Is the company subject to loan covenants or other agreements that may restrict payments to a captive?
10. Is there an appropriate partner/provider available with both risk management and compliance skills to form and manage the new captive insurance company?

by the insured (the parent's company), then the owner of the insurance company (the children or their trust) can eventually recover the profits at capital gains rates."

The concept is predicated on three important factors:

- First, the new insurance company must be formed to assume definitive risks that are actuarially sound and priced adequately.
- Second, the risks transferred must be carefully structured so the new insurance company has a good chance of generating an underwriting profit (i.e., when insured losses and operating expenses are significantly less than premiums contributed).
- Third, the insurance company must comply with the state insurance laws and tax rules to be certain all financial benefits are captured.

There also are other ways to use a private insurance company in estate planning. When the insurance business is profitable, the new company will accumulate a growing reserve of pre-tax dollars. To the extent that these dollars don't have to be paid out in claims, they can be invested in any way, including in life insurance (or as a financing source for life insurance premiums) that is used in the entrepreneur's estate plan.

But Landis cautions against burdening the new insurance company with oversized risk. "It is extremely important that the new insurance company not take on too much risk," he emphasizes. "A risk management tool like a captive insurance company is sensible only if it covers real risks. An unprofitable insurance company is not a useful tool.

"Most financial planners aren't aware of the opportunities available with this risk management tool," he adds. "Again, the income tax consequences of forming and operating a private insurance company weren't always clear. With the clarified IRS rulings, however, the product is now both safe and economically powerful."

THE DIFFERENT CAPTIVES

This article speaks to what is known as a "pure" captive. A "pure" captive supplements existing insurance by focusing on existing self-insured risks without changing the client's risk profile.

Other types of captive insurance companies exist, the most common called a "group captive." These other types of captives, however, are generally formed to replace existing third-party insurance and have a very high risk profile.

HOW TO START

Common sense dictates that a company drill down and discover its true risk management needs and ultimate asset-building strategy before designing a captive to suit its needs. "As a first step, I would advise an organization considering the use of a private insurance company to carefully review the causes of loss that would negatively impact the organization," Bill White says. "Determine the amount of capital the organization is willing to invest in developing risk-bearing capabilities, and develop a strategic plan for financing its risk aimed at providing measurable, long-term benefits for the organization."

And Francis, who led CQG's effort in creating its captive in 2006, notes that experience in creating captives, as well as accuracy in the initial risk assessment, is paramount to the ultimate value of a private insurance company. "The important thing is risk and insurance management expertise," he notes, "exercised at the very beginning of the discussion, in helping to assess risk, write the insurance policies, and ultimately establish the private insurance company correctly.

"A company considering a private insurance company should also be attentive to and concerned about the administration of the entity," he adds. "Partner with someone who can administer on your company's behalf. Done right, you and your company should have to do very little to set the company up and almost nothing to maintain it."

Which is how it went for one Florida company that created a captive. When the company found its wind coverage cancelled by its insurance carrier in the wake of Hurricane Katrina, the company turned to a captive and now sets aside more than $1 million annually in a pre-tax reserve in case another Katrina-like (or even lesser) disaster strikes.

"It is very satisfying to help companies protect their assets," Jim Landis says. "Many companies along the vulnerable coasts are family-owned, and a natural disaster can and does instantly destroy all that. Savvy business owners who have a vision of growing profits and a tolerance for manageable levels of risk intuitively understand the timeliness of today's captive—and what it can do for their company." ■

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